No. 3862.

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of

ELLIOTT-O'BRIEN COMPANY, a Corporation, Bankrupt.

S. G. CLIMENSON, as Trustee of ELLIOTT-O'BRIEN COMPANY, a Corporation, Bankrupt,

Appellant,

vs.

CARSON, PIRIE, SCOTT & COMPANY, a Corporation; COFFMAN, DOBSON BANK & TRUST COMPANY, a Corporation; BEE NUGGET PUBLISHING COMPANY, a Corporation,

Appellees.

BRIEF OF APPELLANT

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BRIEF OF APPELLANT

STATEMENT OF THE CASE.

The trustee filed objections to the claims of Carson, Pirie, Scott & Co. and Coffman, Dobson Bank & Trust Co. on two grounds: that they had

received preferences prohibited (1) by the Bankruptcy Act and (2) by the law of the State of Washington prohibiting insolvent corporations from preferring creditors under the Trust Fund theory.

I.

Carson, Pirie, Scott & Co. filed its claim with the Referee in the sum of $2,976.80 (R. 1, 2).

The written objections of the trustee set up that the bankrupt was a Washington corporation; that petitions alleging bankruptcy were filed May 10, 1921, and that adjudication followed May 17, 1921; that the bankrupt was insolvent during all of 1921; that on January 1, 1921, the bankrupt was indebted to Carson, Pirie, Scott & Co. for $6,590.47; that bankrupt paid Carson, Pirie, Scott & Co. during 1921 $4,254.11; that the bankrupt received from Carson, Pirie, Scott & Co. $667.11 worth of merchandise; that the net depletion of the estate was $3,657.73 during the four months' period; that said net payments paid said creditor 55 per cent of its account, while the remaining creditors (other than those whose claims were objected to) received nothing; that said creditor had reasonable cause to believe that said payments operated as a preference under the Bankruptcy Act.

In a separate paragraph the foregoing facts were realleged, except the allegation of "reasonable cause to believe" was omitted; and it was alleged that said payments operated as a preference under the laws of the State of Washington prohibiting insolvent corporations from preferring creditors under the Trust Fund theory.

The prayer was that Carson, Pirie, Scott & Co. take nothing on its claim until other creditors had received a like dividend of 55 per cent and then that all share equally in further dividends (R. 4-9).

The Reply denied all allegations of preference and set out the true amount of the claim was $2,962.18 (R. 14).

II.

Coffman-Dobson Bank & Trust Co. filed its claim with the Referee in the sum of $1,856.92 (R. 2-3-4).

The written objections of the trustee set up the same state of facts concerning bankruptcy, insolvency and preferences under both the Bankruptcy Act and the State law as in the objections to the claim of Carson, Pirie, Scott & Co., and

alleged that on January 1, 1921, said bankrupt was indebted to said bank in the sum of $5,500.00 upon three notes maturing three months after date; that between April 5, 1921, and May 2, 1921, that is, within thirty-five days of bankruptcy, said bankrupt paid said bank ~~$4,443.08~~ 3,514.10, resulting in the payment of 67 per cent of its claim.

The trustee prayed that said creditor be charged with receipt of a dividend equal to 67 per cent of its claim, and that it take nothing until other creditors had received a dividend of 67 per cent of their claims and then that all share equally in further dividends (R. 9-14).

Orally the bank replied denying generally the allegations of the trustee.

III.

The trustee also objected to the claims of Fleischner-Mayer & Co. to the extent of 9 per cent of its claim, and Royal Worcester Corset Co. to the extent of 9 per cent of its claim; both stipulated they would be bound by the decision of the court on the contested claims; and to the claim of Bee Nugget Publishing Co. to the extent of 20 per cent. The other creditors have been paid nothing on their past due accounts (R. 94-98).

A hearing upon said claims and the objections to them was had before R. F. Laffoon, Referee in Bankruptcy, sitting at Tacoma, who found all the facts constituting a preference in favor of the trustee except that creditors had "reasonable cause to believe" that bankrupt was insolvent at the time payments were made.

The Referee was also of the opinion that the Washington decisions required proof of "reasonable cause to believe" to constitute a preference under the laws of the State of Washington.

An order was entered overruling the objections of the trustee and allowing said claims (R. 15). Thereupon the trustee petitioned the District Court for a review (R. 16). The District Court affirmed the referee's ruling (R. 27), but made no findings of fact and rendered a short opinion of four or five sentences (R. 28).

AMENDED ASSIGNMENTS OF ERROR.

I.

The Court erred in approving the ruling of the Referee allowing the claim of, and overruling the objections of the trustee to the claim of Carson, Pirie, Scott & Co. on the ground of preferences received contrary to the Bankruptcy Act prohibiting preferences to creditors.

II.

The Court erred in approving the ruling of the Referee allowing the claim of, and overruling the objections of the trustee to the claim of, Coffman-Dobson Bank & Trust Co. on the ground of preferences (....) received contrary to the Bankruptcy Act prohibiting preferences to creditors.

III.

The Court erred in approving the finding of fact, if it be a finding, made by the Referee as follows:

That the inventory showing was very good, $26,371.39, and, while *that its* claimant, Carson, Pirie, Scott & Co., was very large, yet the inventory

would seem sufficient to pay it, and that, together with the manager's contention that he would reduce the stock, pay its debts, which he did actually proceed to do, might very easily lead claimant to believe that the manager was reducing all debts and not merely its debts; because same is not supported by, and is contrary to, the evidence.

IV.

The Court erred in approving the finding of the Referee, if it be a finding, as follows:

I do not believe that the claimant had knowledge of the insolvent condition of the bankrupt or sufficient reason to believe that it was receiving a preference; because same is not supported by, and is contrary to, the evidence.

V.

The Court erred in approving the finding of the Referee, if it be a finding, as follows:

Unless claimant had knowledge of the purposes of the dominant stockholder to close out the business is was not likely to suspect insolvency; because same is not supported by, and is contrary to, the evidence.

VI.

The Cout erred in approving the finding of the Referee, if it be a finding, as follows:

The case at bar is distinguished from the cases relied on by the trustee in that the creditor was informed by the manager that he could pay his debts by reducing the stock; because same is not supported by, and is contrary to, the evidence.

VII.

The Court erred in approving the finding of the Referee, if it be a finding, as follows:

That Dan Coffman, cashier of Coffman-Dobson Bank & Trust Co., stated at page 145 of the transcript that the bank was liquidating as any other bank was, and if they had cleared up their notes the Bank would likely have accommodated them again; because same is not supported by, and is contrary to, the evidence.

VIII.

The Court erred in finding that said Carson, Pirie, Scott & Co. did not know or believe or have reasonable cause to believe that the transfers would effect a preference; because same is not supported by, and is contrary to, the evidence.

IX.

The Court erred in not finding that Carson, Pirie, Scott & Co. believed or had reasonable cause to believe that a preference was effected by payments made on account as shown by the evidence.

X.

The Court erred in not finding that Carson, Pirie, Scott & Co. believed or had reasonable cause to believe that a preference was effected by payments made on account of the failure of Carson, Pirie, Scott & Co. to introduce correspondence between it and the bankrupt, and the suppression of same, thereby establishing an inference of fact and a presumption of law that they knew, believed or had reasonable cause to believe a preference was effected.

XI.

The Court erred in finding that said Coffman-Dobson Bank & Trust Co. did not know or believe or have reasonable cause to believe that the transfers would effect a preference; because same is (135) not supported by, and is contrary to, the evidence.

XII.

The Court erred in not finding that Coffman-Dobson Brank & Trust Co. knew, believed or had

reasonable cause to believe that a preference was effected by payments made on account as shown by the evidence.

XIII.

That the Court erred in approving the ruling of the Referee and in allowing the claim of, and not sustaining the objections of the trustee to, claim of Carson, Pirie, Scott & Co., for preferences received contrary to the laws of the State of Washington prohibiting insolvent corporations from preferring creditors.

XIV.

The Court erred in approving the ruling of the Referee and allowing the claim of Carson, Pirie, Scott & Co., because the facts found do not, according to the laws of the State of Washington prohibiting insolvent corporations from preferring creditors, sustain the judgment.

XV.

That the Court erred in approving the ruling of the Referee and in allowing the claim of, and not sustaining the objections of the trustee to, claim of Coffman-Dobson Bank & Trust Co., for preferences received contrary to the laws of the State of Washington prohibiting insolvent corporations from preferring creditors.

XVI.

The Court erred in approving the ruling of the Referee and allowing the claim of Coffman-Dobson Bank & Trust Co., because the facts do not, according to the laws of the State of Washington prohibiting insolvent corporations from preferring creditors, sustain the judgment (136).

XVII.

The Court erred in not giving judgment in favor of the Trustee and against Carson, Pirie Scott & Co., upon the facts found containing all the elements of a preference under the laws of the State of Washington wherein insolvent corporations cannot prefer creditors no matter what the good faith of the creditor may be; knowledge, belief or reasonable cause to believe upon the part of a creditor that a preference was received is immaterial.

XVIII.

The Court erred in not giving judgment in favor of the trustee and against Coffman-Dobson Bank & Trust Co., upon the facts found containing all the elements of a preference under the laws of the State of Washington wherein insolvent corporations cannot prefer creditors no matter what the

good faith of the creditor may be; knowledge, belief or reasonable cause to believe upon the part of a creditor that a preference was received is immaterial. (R. 164-169.)

ARGUMENT.

The assignments of error present two questions. The first is a question of fact: Does the evidence show that appellees had "reasonable cause to believe" that bankrupt was insolvent at the time payments were made effecting a preference as required by the Bankruptcy Act? The second is a question of law: Are preferences void under the law of the State of Washington regardless of whether or not creditors have "reasonable cause to believe" that debtor is insolvent?

The elements of a preference are:

BANKRUPTCY ACT	STATE TRUST FUND
1. Transfer of property.	1. Same.
2. To creditors.	2. Same.
3. Preceding creditors.	3. Same.
4. Voluntary action of debtor.	4. Same.
5. Application upon a debt.	5. Same.
6. Insolvency of debtor—debts greater than assets.	6. Insolvency of debtor—inability to pay bills as they mature in due course of business.
7. Within four months.	7. Within period of insolvency.
8. Greater percentage to creditor than other creditors.	8. Same.
9. Creditor knew or believed, or had reasonable cause to believe debtor insolvent.	9. Good faith of creditor immaterial.

Rem. on Bankruptcy, Sec. 1393.

In passing it may be noted that "reasonable cause to believe" (9) has been defined to be notice or want of good faith (9).

Bassett vs. Evans, 253 Fed. 532 (8 C. C. A.).

The Referee found all of the elements necessary to constitute a preference under the Bankruptcy Act except that the creditors knew, believed, or had reasonable cause to believe that debtor was insolvent (R. 17-26).

As to insolvency, the Referee said:

> "I have no doubt from this resume of figures that the bankrupt was insolvent in December, 1920, when the manager, as stated, started in to reduce the stock and pay the debts. The manager made every possible effort to reduce the stock and to pay the debts during January, February, March and up to April 25, when he abandoned the business and took service with the claimant herein, as he said, because he had no further interest in the business (R. 21).

The facts found in the record, interpreted in the light of the bankruptcy rule, show plainly, we think, that Carson, Pirie, Scott & Co. and the Bank not only had reasonable cause to believe that the debtor was insolvent, but that they actually knew it.

The test is well stated in the 1921 edition of *Collier on Bankruptcy* (12th edition), p. 912:

> "A creditor has reasonable cause to believe a debtor to be insolvent when such a state of facts is brought to the creditor's notice, respecting the affairs and pecuniary condition of the debtor, as would lead a prudent business man to the conclusion that he is unable to meet the payment of his obligations as they mature in the ordinary course of business. Where the creditor knew that the debtor's business was bad and it was necessary to continually press the debtor for payment the creditor must be said to have had reasonable cause to believe that the debtor was insolvent and that the preference was intended." Citing
>
> *Nat. Bank of Bakersfield vs. Moore,* 247 Fed. 913 (9 C. C. A.).

Id., page 909:

> "If insolvency is known to exist, or if the creditor had reasonable cause to believe that it existed, he will be presumed to have 'reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference.'"

See 7 C. J. 153.

In *Healy vs. Wehrung,* 229 Fed. 686, 36 A. B. R. 673 (1916), this Court said:

> "In so far as creditors are concerned, the purpose and policy of the Bankruptcy Act is the equal and equitable distribution of the bankrupt's estate among them, subject only to the preferences or the priorities therein ex-

pressly allowed. From all the facts and circumstances shown by the record here, we regard it as clear that not only did the appellee, Wehrung, have reasonable cause to believe that by the payment to him he was thereby given a preference, but that the sale of the bankrupt's land which he initiated and caused to be consummated was all done for the very purpose of securing to himself, to his mother, and the bank of which he was president, such preferences. See *Toof vs. Martin,* 13 Wall 40, 20 L. Ed. 481; *Wager vs. Hall,* 16 Wall 584, 21 L. Ed. 504; *Coder vs. McPherson,* 152 Fed. 951, 82 C. C. A. 99; *In re McDonald & Sons* (D. C.), 178 Fed. 487; *Ogden vs. Reddish* (D. C.), 200 Fed. 977; *Heyman vs. Bank* (D. C.), 216 Fed. 685."

In *Toof vs. Martin, supra,* the United States Supreme Court said:

> "And reasonable cause they must be considered to have had when such a state of facts was brought to their notice in respect to the affairs and pecuniary condition of the bankrupts as would have led a prudent business man to the conclusion that they could not meet their obligations as they matured in the ordinary course of business."

Other decisions of this court are:

In re Dorr, 196 Fed. 292, 116 C. C. A. 112, 28 A. B. R. 505.

Stock Growers State Bank of Mountain Home vs. Corker, 220 Fed. 614.

National Bank of Bakersfield vs. Moore, 274 Fed. 913, 41 A. B. R. 409.

In the matter of *States Printing Co.,* 238 Fed. 775, 38 A. B. R. 526, the Circuit Court of Appeals for the Seventh Circuit, said the test was:

> "Would the ordinary or the ordinarily intelligent man, with the same facts before him, have believed debtor was insolvent."

In *Bassett vs. Evans,* 253 Fed. 532, 42 A. B. R. 587, the Circuit Court of Appeals for the Eighth Circuit, said:

> "Courts must hold parties standing in the position which appellees occupied to have 'reasonable cause to believe' what a sensible business man, standing in their place and possessing their knowledge, would have believed."
>
> "Thus between actual knowledge and actual belief on the one side, and fear and suspicion on the other, lies the 'reasonable cause to believe' mentioned in the statutes. This classification, however, is not as helpful in the decision of a concrete case as it appears. Fear and suspicion of insolvency, if they be strong enough, become belief, etc."
>
> "What the statute requires is that the facts and circumstances known to the purchaser shall be ascertained and then the question answered whether those facts and circumstances would have caused an intelligent business man to believe that the preference was intended, or would have put the man upon an inquiry that would have discovered the true character of the transaction."

The Circuit Court of Appeals for the Third Circuit, *in re Star Spring Bed Co.,* 265 Fed. 133, where

the bank's officers testified that they had neither knowledge nor belief that the Star Co. was insolvent, said:

> "Such evidence, however, is neither controlling nor of much, if any, weight; for under Sec. 60-B of the Bankruptcy Act, the facts surrounding and attending the transfer were such as to cause a reasonably prudent man to believe that the bankrupt was insolvent; or were such as to put such a person on inquiry touching the solvency of the debtor, and such inquiry would have disclosed insolvency, the transfer is voidable."

Concerning the withdrawal of 64 accommodation notes upon the explanation that the makers wanted them back, the Court said:

> "More obvious indications of insolvency it would be difficult to conceive; but if these facts would not alone give the bank reasonable cause to believe that the Star Co. was insolvent, they were more than sufficient to put it on inquiry.
>
> "Under these circumstances we believe that a reasonably diligent inquiry would have uncovered the existing insolvency of the Star Co. It was the bank's duty under the law to make such inquiry, yet it accepted the assignment and completed the transaction without investigation.
>
> "Notwithstanding its inaction, it is chargeable with such knowledge as investigation would have disclosed. Lethargy under such circumstances is not rewarded by the law."

In the matter of *Sutherland Co.,* 245 Fed. 663, 40 A. B. R. 305, the court said:

"It is true that Mr. Holcomb does not appear to have had any information as to the total indebtedness of the Sutherland Company, nor as to the value of its assets. Knowledge on these points can but seldom be brought home to persons accepting preferential payments; nor is it necessary. Reasonable cause to believe in such cases is usually inferred from circumstances very similar to those which exist here, *i. e.*, from inability to pay bills in the usual course of business as they mature, from poor business and from transactions of a character not ordinarily resorted to by solvent traders."

"He was bound to draw such inferences as would naturally follow from the facts coming to his attention; and, where those facts would ordinarily excite suspicion as to solvency and cause inquiry, he is to be held to such knowledge as a reasonable inquiry would have furnished.

"Anything sufficient to excite attention and put a party on inquiry is notice of everything to which such inquiry would have led."

In *Coder vs. McPherson,* 152 Fed. 951, 82 C. C. A. 99 (8), the Court said:

"Notice of facts which would incite a man of ordinary prudence to an inquiry under similar circumstances is notice of all the facts which a reasonably diligent inquiry would disclose."

Appoved:

Wright vs. Skinner, 162 Fed. 315, 89 C. C. A. 23 (2).

Gandison vs. National Bank of Commerce, 231 Fed. 800 (2).

Bassett vs. Evans, 253 Fed. 532 (8).

Healy vs. Wehrung, 229 Fed. 686 (9).

In *Marks Ribbon Co. vs. Pilsbury,* 278 Fed. 161 (5), the Court said that a creditor had reasonable cause to believe if the creditor "believed that debtor already was or soon would be insolvent within the meaning of the Bankruptcy Act"; if creditor believed he "was likely to lose his debt in whole or in part by failure to obtain prompt payment of it."

In re Gaylord, 225 Fed. 234, the Court said:

> "Financial embarrassment is not necessarily insolvency, but may under certain circumstances suggest it and put the creditor on an inquiry."

In re Campion, 256 Fed. 902, the court said:

> "He may not have reasonable cause to believe at a given time, and still have knowledge of such facts as would put a reasonable man of intelligence on inquiry as to the financial condition; and if he does have such knowledge it is his duty to inquire, and such inquiry may disclose the facts which give the necessary reasonable cause to believe that the enforcement of a transfer would work a preference."

Scheurer vs. Katzoff, 233 Fed. 473, 37 A. B. R. 476.

JUDICIAL NOTICE.

The Court may take judicial notice of the financial depression existing throughout the country in 1920 and 1921.

In re B. & R. Glove Corporation, 279 Fed. 372 (2).

EVIDENCE.

In the light of the foregoing principles of law let us look at the evidence relating to "reasonable cause to believe" upon the part of Carson, Pirie, Scott & Co.

The payments of bankrupt to Carson, Pirie, Scott & Co., objected to by the Trustee as preferential, are as follows:

Jan. 25, 1921	$ 265.50
27, 1921	495.55
Feb. 4, 1921	517.54
24, 1921	661.59
Mar. 5, 1921	715.80
Apr. 1, 1921	589.66
25, 1921	500.00
29, 1921	508.47
	$4,254.11

(R. 6, 21, 22, 153, 154.)

1917 to December 31, 1920.

1917, W. F. Elliott and Ed. O'Brien, who had been employees of Carson, Pirie, Scott & Co. for ten and thirty years, respectively, organized the Elliott-O'Brien Co., a Washington corporation (R. 46), with a capital stock of $15,000.00. The company embarked in the retail dry goods business at Chehalis, Washington (R. 47). Ed. O'Brien died in 1918 (R. 47) and his brother, Charles O'Brien thereafter looked after the O'Brien interests. Charles O'Brien is also an employee of Carson, Pirie, Scott & Co. He has been with them for 30 years (R. 47) and is a pensioner of Carson, Pirie, Scott & Co. (R. 61), maintaining a desk in its place of business, and dictated the policy of the business in 1920 from Chicago (R. 47).

November, 1920, Charles O'Brien came to Seattle and met Mr. Elliott and Mr. LeSourd, who is trust officer for the Dexter Horton National Bank, the executor of the will of Ed. O'Brien, deceased. Mr. O'Brien was dissatisfied with the way things were going—the way the store was conducted—the present condition of the store, and spoke of closing it out (R. 34). They discussed the bankrupt's affairs and were of the opinion that the bankrupt was

carrying too large a stock and that its indebtedness was too large, and they agreed to reduce the stock in order to pay off the indebtedness, and further agreed to offer the business for sale (R. 34, 37, 38). Mr. O'Brien said Carson, Pirie, Scott & Co. wanted to be treated the same as other creditors—wanted to be paid (R. 61); not to buy any more goods from Carson, Pirie, Scott & Co. until its account was paid up (R. 62).

Duing 1917, 1918, 1919 and 1920 Carson, Pirie, Scott & Co. was the principal creditor of the bankrupt (R. 20, 54). It sold bankrupt over 75 per cent of all its dry goods, and over 50 per cent of all its purchases (R. 59). During 1920 it extended credit of $16,000.00 to this $15,000.00 bankrupt corporation (R. 55). On December 9, 1920, part of its account was 373 days old (R. 60).

With Carson, Pirie, Scott & Co. practically financing the bankrupt up to January 1, 1921, the bankrupt paid its other creditors promptly, even discounting its bills with other creditors (R. 71). Referring to Mr. Elliott's presence in Seattle in November, 1920, and the conference taking place at that time, Mr. Elliott said:

"Of course the Carson, Pirie, Scott indebtedness was the largest part of it, and was long past due. Nothing else was past due. We did not owe a dollar (of past-due indebtedness except to Carson, Pirie, Scott & Co.). Our statement will show that in November, December and January there was nothing else past due; everything was up in shape. Everythiing was paid in January, and everything was paid in February and we did not owe anybody. Nobody was wanting their money. *Carson, Pirie, Scott did not have to have that money; and we did not have to pay them.* We took advantage of all our discounts that came along, except the Carson-Pirie-Scott Co." (R. 71).

"Q. (Mr. McClure) And how did that happen to be in that condition?

A. We always had a standing account with them.

Q. They always had a substantial claim against the Elliott-O'Brien Co.?

A. Oh, yes; they always had a big claim,—a substantial account with them ever since we began business—which had been past due.

Q. There was nothing unusual about the past due claim then?

A. Not after the first six months we were in business.

Q. In your other debts, except the bank, business, you kept up?

A. Absolutely. Of course I might make an exception, in those last months, January, February and March, we could not take care of our indebtedness, as our books will show, and then we owed two other accounts besides Carson,

Pirie, Scott, that is, Fleischner Mayer and Western Dry Goods Company, but nobody else. That was in March" (R. 71, 72).

Concerning business conditions Mr. Le Sourd said:

"Prices had been dropping in merchandise during the fall of 1920 quite rapidly, and more rapidly in the spring. I could not say how much more rapidly in the spring than in the fall, because I am not familiar enough with the dry goods business to answer that (R. 43, 44).

"Of course, we all recognized the fact that a business like that, carrying merchandise stock of from $25,000 to $30,000 and an indebtedness running up to $15,000 or $20,000, is always in danger. It is not good business, and we wanted to reduce the stock and reduce the indebtedness at the same time, and operate the same in a better financial position; and then it would not take so much cash to buy it" (R. 45).

1921.

January 1, 1921, the indebtedness of the bankrupt to Carson, Pirie, Scott & Co. was $6,590.47 (R. 55, 56; Trustee's Ex. C at R. 153, 154).

As to business conditions in 1921, Mr. Elliott said:

"The bottom simply fell out of business in January, not only in Chehalis, but everywhere. Values went down and there was not any business, absolutely no business. We put in as much advertising in January as we did in De-

cember, and the sales will show,—our sales in January show $6,000 approximately, and in December they were a little over $16,000. We had put forth the same effort in January as we had in December. There was absolutely no business.

Q. That slump continued how long?

A. That slump continued, and when I left the business was then very quiet. Of course the merchandise was really receding every month" (R. 75).

"During January, February and March, 1921, bankrupt was unable to take care of its bills, as the books will show, testified Mr. Elliott. "Yes, some of these bills were really a year past due, at least, eight months past due, making a year's time" (R. 60).

The bankrupt's ledger shows:

	Merchandise Past Due	Merchandise Not Due	Bank	Total
January	$3,970.68	$7,108.15	$5,500.00	$16,578.83
February	3,436.14	9,291.39	5,500.00	18,227.53
March	4,788.79	9,527.45	5,500.00	19,816.24
April	8,693.19	3,823.42	5,500.00	18,116.61

(Trustee's Ex. B at R. 152).

January, 1921, the bankrupt decided to sell out and quit business (R. 49-50).

February, 1921, Carson, Pirie, Scott & Co. refused credit to the bankrupt, and from January 1, 1921, to date of bankruptcy, May, 1921, Carson, Pirie, Scott & Co. sold bankrupt only $566.50 worth of merchandise (R. 153, 154); in 1921, the bankrupt

purchased from the other creditors, who are represented by the trustee, $10,582.50 worth of merchandise (R. 19, 54, 152).

February, 1921,

> "They refused to ship us any more merchandise until we paid our past due bills. We wanted to buy our spring merchandise and they refused to ship it to us unless we would pay more on our past due bills" (R. 60).

On February 17, 1921, Coram T. Davis, attorney for Carson, Pirie, Scott & Co., with offices in the dry goods house of Carson, Pirie, Scott & Co. (R. 51), who represented that company in its financial dealings with bankrupt (R. 51, 143), wrote a letter to Mr. Le Sourd of the Dexter Horton National Bank, as follows:

> "It would be best for all concerned to have this business closed out as speedily as possible" (R. 116).

On February 18, 1921, Le Sourd wrote C. H. O'Brien, care of Coram T. Davis, Carson, Pirie, Scott & Co.:

> "Mr. Elliott seemed to think that on account of present conditions *no advantageous sale could be made, and Mr. Hart joined* with him in this position. They both claimed a greater return could be accomplished by *putting on a closing out sale,* which we understand they are now doing. Mr. Hart has returned to Che-

halis with Mr. Elliott, telling me that the only cost Elliott-O'Brien would be put to—would be the actual expenses. I have talked with Mr. Adams of the local Carson, Pirie and Scott Co. office, and have him on the lookout for a prospective purchaser" (R. 117).

On March 12, 1921, Le Sourd telegraphed Davis:

"Fear receivership if business drifts along. What do you think of the proposition" (R. 119, 120).

On March 16, Le Sourd wrote Davis concerning:

"the plan to close the store out by disposing of the stock gradually to customers until it has been reduced to ten thousand or fifteen thousand, when it will be easier to find a purchaser. This probably is going to be difficult to accomplish, however, *as someone might step in and demand that a receiver be appointed.* The stock is evidently worth something in excess of the debts, but it is going to be another question to realize on the stock as rapidly as the obligations mature" (R. 123, 124).

On April 14 Le Sourd wrote Davis:

"A special sale has been put on this month, employing a specialist from Portland who guaranteed to unload $20,000.00 worth of stock in thirty days. It appears that the sale has been a failure, largely for the reason that people are unable to buy because of quiet times in the Northwest, and in Chehalis in particular. The store has been advertised for sale,—but no one

appears to be especially interested in the matter, as Chehalis seems to have a very black eye in so far as the dry goods business is concerned. Mr. Hart thinks it will be impossible to avoid a receivership unless someone is found within the near future to buy the store as a going proposition" (R. 141).

On April 23 Le Sourd again wrote:

"That the indebtedness would run in the neighborhood of nineteen thousand dollars and that if it seems impossible for the store to pay its debts we would suggest that the stock be turned over to the creditors at once" (R. 148-150).

In March, 1921, Elliott wrote Carson, Pirie, Scott & Co. asking for a position as salesman on the road (R. 49-73-79). Elliott was employed by them the first part of April, 1921 (R. 49); thus, the last of March Carson, Pirie, Scott & Co. knew that Mr. Elliott, manager and only officer in the United States of the bankrupt, was planning to abandon the concern.

Carson, Pirie, Scott & Co. also knew debtor was seeking a purchaser for the store (R. 51).

April 26, 1921, Elliott abandoned the business and became a salesman for Carson, Pirie, Scott & Co. (R. 48, 49). He left it in charge of Mr. Hart,

formerly employed by Carson, Pirie, Scott & Co. (R. 141).

The bankrupt was conducting special sales continuously during November, December, January, February, March and April; it had signs across the face of its store in April advertising a "closing out" sale. The bankrupt advertised extensively — "Came out with special advertising and filled the town. We got seven thousand circulars out and we mailed some of them and covered the whole territory there" (R. 62, 63). The bankrupt advertised in January or February in the Portland Oregonian and the Seattle Times for a purchaser for its business (R. 49).

April 1 the bankrupt called in a special sales agent from Portland to put on a special sale. Prices were slashed in order to raise money (R. 87).

The testimony in this case was given by Mr. Le Sourd, who was the Seattle representative of Mr. O'Brien, who has been pensioned by Carson, Pirie, Scott & Co., by Mr. Elliott, who is now employed by Carson, Pirie, Scott & Co., and who was brought to court by the attorneys for Carson, Pirie, Scott & Co., and by Mr. Hart, who was formerly employed by Carson, Pirie, Scott & Co. Claimants under cross

examination of their own witnesses developed facts that they considered helpful to themselves.

The Trustee was never able to locate the correspondence file of the bankrupt, nor its cancelled checks or check stubs. It appeared at the hearing before the Referee that Mr. Elliott had carried off part of the correspondence between bankrupt and Carson, Pirie, Scott. He was ordered by the Referee to forward to the Referee within thirty days all letters in his possession, but has failed to do so (R. 51).

Carson, Pirie, Scott & Co. did not offer any of the correspondence exchanged between it and the bankrupt. It kept its own correspondence tight in its own files and failed to offer the best evidence that could exist of its knowledge or lack of knowledge of the insolvency of the bankrupt. In such cases there is a well-established inference of law that such evidence, if produced, would have been fatal to its case.

> "The failure of a party to call an available witness possessing peculiar knowledge concerning facts essential to the party's case, direct or rebuttal, or to examine such witness as to the facts covered by his special knowledge, especially if the witness would naturally be favorable to the party's contention, relying instead upon the evidence of witnesses less familiar with

the matter, gives rise to the inference that the testimony of such uninterrogated witness would not sustain the contention of the party."

(22 C. J. 115, 116.)

"The brother was not called as a witness. He alone knew the actual facts of the transaction. It was clearly in defendant's power to have produced him and the defense of good faith required him to do so. Failure to call this witness justifies the inference that, if he had been called, his testimony would have been fatal to defendant's case."

Hill vs. U. S. (C. C. A. 8), 234 Fed. 39.

See also:

Herald vs. Tooney, 92 Wash. 297.

Kirby vs. Talmadge, 160 U. S. 379, 16 Sup. Ct. 349, 40 L. Ed. 463.

It seems to the Trustee that this case is remarkably free from doubt and very clear that "reasonable cause to believe" was abundantly established.

Taking into consideration the intimate relations existing between Mr. Elliott and the two O'Briens with Carson, Pirie, Scott & Co.; the fact that debtor was known as a "Carson, Pirie, Scott & Co. store" by virtue of an extension of credit for $16,000.00 in 1920 (R. 55), and its purchase of 75 per cent of its dry goods from Carson, Pirie, Scott & Co. up to

February, 1921 (R. 59); the refusal in February to sell any more goods on credit; the slump in business throughout the U. S.; the fact that bills of Carson, Pirie, Scott & Co. were *more than one year old;* that Carson, Pirie, Scott & Co. on March 12 knew past due and not due amount of bills of bankrupt (R. 119, 120); the disagreements between Elliott and O'Brien; the correspondence going to Coram T. Davis, attorney for Carson, Pirie, Scott & Co., whose offices are in the dry goods house of Carson, Pirie, Scott & Co., with its *warnings that a receivership was imminent;* the notice in March to Carson, Pirie, Scott & Co. from Elliott that he *intended to abandon the business* while Mr. O'Brien, a pensioner of Carson, Pirie, Scott & Co. was down in the Bermudas; its knowledge that bankrupt was seeking a purchaser for the store; its employment of Mr. Elliott the first of April as one of its salesmen,—we think the ordinary business man or the ordinarily intelligent man, with these facts and circumstances before him, would have believed the bankrupt was insolvent, and consequently that the payments were preferential.

It seems to us a misuse of the English language to say these facts would not put a man of ordinary prudence on inquiry.

The course of dealing between this creditor and this debtor is significant indeed. In 1917, 1918, 1919 and 1920 Carson, Pirie, Scott & Co. was the principal creditor of bankrupt. It extended credit to such a large extent as to practically finance bankrupt; it extended a $15,000.00 corporation credit of $16,000.00 in 1920; the amount was long past due, part of it over one year old. The indebtedness was reduced January 1, 1921, to $6,590.47.

As long as Carson, Pirie, Scott & Co. extended credit running into the thousands, and as high as $16,000.00, and carried them along, allowing the account to take a year's time for payment, the bankrupt paid its other bills and took discounts from creditors generally, as the record shows. But when in the fall of 1920 Carson, Pirie Scott & Co. began to collect in its account and reduced its account due from bankrupt to $6,590.47 by Jan. 1, 1921, and shut off credit altogether in February, the bankrupt "could not pay its bills, as the books will show."

The creditors represented by the trustee delivered merchandise to the bankrupt in 1921 amounting to $10,582.50 (R. 19, 54, 152). Carson, Pirie, Scott delivered $566.50.

Carson, Pirie, Scott received payments of $4,254.11 covering its current account of $566.50 in full and a balance of $3,657.73 to apply on its old account, resulting in paying 55 per cent of said account.

The record shows the amount of indebtedness remained about the same. It was switched from appellees to the other creditors. The indebtedness of the bankrupt on Jan. 1, 1921, was $18,751 (R. 162). At the time of bankruptcy it was $16,740.29 (R. 21).

The Jan. 1 indebtedness of $18,751 was made up as follows:

Carson, Pirie, Scott & Co.	$6,590.47
Bank	5,500.00
	$12,090.47
Other creditors	6,661.00
	$18,751.00

By May, or date of bankruptcy, the indebtedness of $16,740.29 was made up as follows:

Carson, Pirie, Scott & Co.	$2,962.78
Bank	1,856.92
	$ 4,819.70
Other creditors	11,920.59
	$16,740.29

Its refusal of credit to a store that it had practically financed and which was one of its best cus-

tomers, is a plain and forcible statement of what creditor thought of debtor's financial condition. It conclusively shows that creditor had formed adverse judgment and considered debtor's condition bad, that it had lost faith in the enterprise and wanted to get out and close up what had been one of its best accounts. From its own account it knew debtor was in straightened circumstances, that it could not take care of its bills, and it knew, as every merchant in the United States in 1920 and 1921 knew, with the dry goods market sloughing off approximately 50 per cent, that hard times were ahead for a concern that could not pay its bills. They reversed their policy and started in to reduce their account as rapidly as possible and at the same time to furnish no more goods.

What plainer statement could be made to the creditor that debtor was broke than to notify him that a receivership was imminent (March 12, 1921); that someone might step in and demand that a receiver be appointed (March 16, 1921); that it will be impossible to avoid a receivership unless a buyer is found in the near future (April 23, 1921)?

What inference would the average business man draw from the receipt of a letter in March, 1921, from the manager and only officer of debtor corpora-

tion in the United States, saying he is going to quit and asking for a job? Giving him a job the first part of April? Pulling out and abandoning the business on April 26th?

Knowledge that debtor was running special sales continuously and advertising for a purchaser would naturally raise an inquiry in the creditor's mind as to the debtor's solvency or insolvency.

The record shows that Le Sourd had "reasonable cause to believe"; for he told the bank on April 22 that it could not take from debtor a thousand dollars a week and debtor still continue to do business (R. 35, 36). The record shows that Hart in his letters and in his oral testimony, also had "reasonable cause to believe"; for he said that he realized the first week in April that they could not continue in business if the bank insisted on payments of $1,000 a week (R. 129, 130).

We think some of the foregoing circumstances standing alone would constitute reasonable cause to believe; that all the facts and circumstances taken together are more than sufficient; that this case is stronger on its facts than the cases heretofore decided by this court and cited hereinbefore.

The trustee believes that the facts are more than sufficient to show that Carson, Pirie, Scott & Co. and the bank had reasonable cause to believe, at the time they received payments on their accounts, that the bankrupt was insolvent; that the ordinarily intelligent business man would, under the circumstances shown to exist, have had good reason to be apprehensive about his account. In fact, every wholesaler and banker in the country were extremely vigilant during 1920 and 1921, as to their accounts receivable, owing to the financial depression existing throughout the country. The years 1920 and 1921 were critical years for business men, and their credit departments were more sensitive and vigilant as to the collectibility of their accounts than in prosperous times or in normal times.

It is truly an amazing thing to read the opinion of the District Court that during a period of drastic deflation, etc., that notice of insolvency should be shown with much greater clearness than can be contended was done in the present case. From actual experience every business house in the country well remembers that during the period of inflation when the market was rapidly rising and the markup on merchandise was very great, and business was consequently prospering, that credit was liberally ex-

tended and that the credit department rested on its oars. But when the tide turned and prices went down and all merchants were subjected to heavy losses, and inventories based on cost price were known to be fictitious, when credits tightened and insolvencies commenced to manifest themselves in bankruptcy, insolvency proceedings in the state court, voluntary assignments and settlements outside of court, and the affairs of every debtor were subject to close scrutiny and question, it required very little evidence of danger to make a credit man apprehensive and to raise an inquiry in his mind as to the solvency of his debtors' accounts.

> " 'One swallow does not make a summer,' but when we see the sky full of swallows homeward flying, and are not aware of the season of the year, we well may inquire, 'Is not summer here?' "

In re Campion, 256 Fed. 902.

COFFMAN-DOBSON BANK & TRUST CO.

On January 1, 1921, the bank accepted three renewal notes from debtor in the sum of $5,500.00, maturing three months after date (R. 112). These notes were collected as follows:

April	5	$ 500.00
	9	500.00
	9 Interest	1.55
	14	500.00
	19	500.00
	23	500.00
	27	500.00
	30 Interest	12.55
May	2	500.00
		$3,514.10
		143.08
May 4 balance on deposit appropriated		143.08
		$3,657.18

The balance as per claim filed is $1,856.92.

The bank is located just across the street from the bankrupt's store; the bankrupt was conducting special sales during November, December, January, February and March; during April it had signs across the face of its store advertising a "closing out" sale; the bankrupt advertised extensively; "came out with special advertising and filled the town. We got seven thousand circulars out and mailed some of them and covered the whole territory there" (R. 62, 63).

In January or February the bankrupt advertised in the Portland Oregonion and the Seattle Times for a purchaser for its business (R. 49); the bankrupt

was negotiating with prospective purchasers for its store during January, February and March (8. 49); the bank knew that the bankrupt had purchasers in view (R. 109).

On April 1, 1921, the bankrupt, by its own books, was overdrawn at the bank in the sum of $309.99 (R. 53), but an overdraft did not appear on the bank's books until April 9, when an overdraft appeared of $16.20.

The bankrupt's balances with the bank, as shown by the bankrupt's books, were as follows:

Jan. 1, '21	$177.57
Feb. 1, '21	284.10
Mar. 1, '21	89.28
Apr. 1, '21 o. d.	309.99

The deposits with the bank during April, 1921, were small:

April	1	$ 408.85	April	16	$ 240.01
"	2	403.23	"	18	327.19
"	3	816.65	"	19	827.95
"	5	344.77	"	20	215.81
"	6	291.65	"	21	173.04
"	7	347.06	"	23	622.80
"	8	146.00	"	25	1,199.51
"	9	265.63	"	26	414.44
"	11	393.28	"	27	353.03
"	12	126.63	"	28	385.30
"	13	202.72	"	29	255.68
"	14	403.79	"	30	234.36
"	15	379.75	May	3	239.32

(R. 111, 112).

The bank's ledger-sheet shows the small balances of the bankrupt with the bank as follows:

April	1	$ 357.69	April	19	$ 736.00
"	1	683.66	"	20	742.83
"	2	1,221.19	"	21	864.78
"	5	10.51	"	22	861.28
"	6	242.16	"	23	369.71
"	8	223.42	"	25	1,281.72
"	9	Overdraft 16.20	"	26	1,461.66
"	11	180.58	"	27	616.07
"	12	282.21	"	28	964.62
"	13	129.24	"	29	720.30
"	14	33.03	"	30	928.78
"	15	412.78	May	2	427.65
"	16	452.79	"	3	158.50
"	18	751.15	"	4	143.08

(R. 110, 111).

The record shows that the first payment made the bank was on April 5, in the sum of $500.00 (R. 11). The bank's ledger-sheet shows that after the bank received its $500.00 on April 5, that the balance in the bank was $10.51 (R. 111).

The second payment to the bank was $500.00 on April 9, and caused an overdraft of $16.20. The third payment on April 14, of $500.00, left a balance in the bank of $33.03. Payments of $500.00 on the 19th, 23rd, 27th of April and on May 2 left balances of respectively $736.00, $369.71, $616.07 and $427.65, and a final balance on May 4 of $143.08, which the bank applied on its account.

An inspection of the deposits with the bank and the balances on hand on the days of payment, and the balances on the days in between, show that the bankrupt and the bank built up the balances so that they could take out payments of $500.00 every four or five days.

The notes fell due on April 1 and on April 1 the bank demanded payment of said notes, amounting to $5,500.00; the bank made a determined stand for payment of its account at that time (R. 85). The bank said that other creditors were paid and they were not (R. 85).

Describing the attitude of the bank, Mr. Hart, assistant manager of the bankrupt, wrote Le Sourd on April 8:

> "The sale is not coming up to expectations, the average sales not going over $275.00 daily so far. As the bank has taken a *determined stand for immediate payment of their loan,* or at least $1,000.00 a week, I am fearful that some creditors might step in and close it up. There are several accounts long past due and I cannot see how they can be satisfied to the extent of allowing us to continue much longer on the basis we are now conducting business" (Trustee's Ex. A, R. 129, 130) (our italics).

Concerning this letter Mr. Hart testified:

> "That was based on the amount of business we were doing, and if we had to pay the

bank, we were satisfied we could not do it and some of the rest of the creditors would step in" (R. 86).

The officers of the bankrupt were satisfied that the business could not continue any longer on the basis on which it had run without someone stepping in and suing them and closing them up (R. 86). This conclusion was reached April 8, 1921 (R. 86).

Mr. Hart said from the deposits the bank knew the sale was not going well (R. 87); that he told him (bank) that in order to do business at all we had to slash prices to such an extent it would mean there would be no surplus over and above the liquidation of the wholesale bills and what was due the bank" (R. 87).

The bank knew by April 12, that Elliott was going East and had withdrawn from the business (R. 78-79).

On April 22, Mr. Le Sourd told Mr. Donohue, vice president of the bank, that he had been informed that the bank had made a demand on the company for the payment of one thousand dollars a week and that Mr. Hart was going to be in charge of the store; that the store was not taking in a great deal of money and that the bank should not expect

them to pay everything that was taken in at the store on the bank's claim; that the store could not be kept running in that way (R. 35, 36).

The bank knew that the deposits for April amounted to $9,779.13 (R. 111, 112); that Carson, Pirie, Scott & Co. took $1,598.23; that the bank took $3,513.10; that the expenses amounted to $2,806.29 (R. 152), and that other creditors received about $800.00.

These two creditors took during April $5,111.33 out of $5,900.00 disbursed to creditors.

The Referee's certificate to the effect that the banker said he would likely have loaned them money after they had taken up the indebtedness of $5,500.00, must be considered in the light of the testimony of the banker, which is as follows:

> "Q. If they paid you off in full at the rate of $1,000 a week they would not have any credit with the bank to do business in paying for their merchandise bills, would they?
>
> A. Well, that would have been left to us to judge after they were paid."

A banker, better than any other creditor, knows the financial condition of its debtor. All its money passes through his hands. He knows the amount of sales day by day; he knows the amount of money on

hand. In this case he knew the sales were small; he knew that what money was raised, was raised by slashing prices through a special sales agent and under heavy pressure. From the amount of deposits he knew the sale was not a success. He knew the balances on hand were very small. He knew he was being paid and that other creditors were not. *He must have known, just as the officers of the bankrupt testified, that they could not pay the bank $1,000 a week and continue to do business...* In fact, on April 22, Mr. Le Sourd told the vice president of the bank that the store could not pay the bank $1,000 a week and still do business. After that plain statement of one banker to another the bank collected in $1,512.55. *What other people knew and believed the bank must also have known and believed.*

Courts are not impressed by pleas of ignorance by banks as to the financial condition of their customers, especially when located in small towns.

In re McDonald & Sons, 178 Fed. 487, cited in *Healy vs. Wehrung,* 229 Fed. 696 (9).

Matter of Brayton, 47 A. B. R. 388.

Thompson vs. Huron Lumber Co., 4 Wash. 600, 604.

The fact that the bank knew that the bankrupt was trying to sell out would naturally have put it on inquiry. The fact that Mr. Elliott, manager of the bankrupt, was quitting the business, abandoning it and leaving for the East to take a position as salesman, would notify any man that the concern was broke and that the day of reckoning was at hand. The bank knew, as everyone would know, that if it took $1,000 a week out of the account of the bankrupt, other creditors could not be paid and that it was getting a preference.

Any inquiry that the bank would have made the first of April would have shown it by an inspection of the bankrupt's ledger that its merchandise bills were long past due and that it was not paying its merchandise creditors as their accounts came due. The fact that the bank complained that other creditors were being paid and they were not, and that they made a determined stand for payment, shows the mental attitude of the bankers toward a customer they had been carrying for four years.

Applying the test of the Bankruptcy Act to this creditor it seems hardly a debatable issue that the bank had reasonable cause to believe that the concern was insolvent and consequently that it was receiving a preference.

PREFERENCES UNDER STATE LAW.

I.

At the oral argument the District Court raised the question of the right of a Trustee in Bankruptcy to recover a preference under the state law prohibiting insolvent corporations from giving a preference. The right of a Trustee cannot be doubted. Section 8 of Act of June 25, 1910, amending Section 47, cl. 2, of Act of 1898 (36 Stat. 840), provides that a Trustee

> "shall be deemed vested with all the rights, remedies and powers of a judgment creditor holding an execution duly returned unsatisfied." Section 70 E, Bankruptcy Act, provides:
>
> > "The Trustee may avoid any transfer by the bankrupt of his property which any creditor of such bankrupt might have avoided, and may recover the property so transferred, or its value, from the person to whom it was transferred, unless he was a *bona fide* holder for value prior to the date of the adjudication."

In *Stellwagen vs. Clum,* 245 U. S. 605, 41 A. B. R. 1, a question arose as to the right of a Trustee in Bankruptcy to rely upon the statutes of Ohio prohibiting preferential transfers. The court held the right of the Trustee was expressly given by Sec.

70 E. After quoting said section Mr. Justice Day said:

> "This section as construed by this court gives the Trustee in Bankruptcy a right of action to recover property transferred in violation of state law.
>
> "And a right of action in this subdivision is not subject to the four months' limitation or other sections (60 B, 67 E) of the Bankruptcy Act. In this subdivision, if a creditor could have avoided a transfer under state law, a Trustee may do the same."

In *Grandison vs. Robertson,* 231 Fed. 785 (2d C. C. A.) the Trustee in Bankruptcy alleged that an insolvent corporation had given a preference contrary to the bankruptcy act and contrary to the statutes of New York prohibiting insolvent corporations from giving preferences. The court held there was no preference under the Bankruptcy Act, but that there was a preference under the state statutes and that the Trustee in Bankruptcy could assert the rights of creditors under the state statute by virtue of Sec. 67 E of the Bankruptcy Act and that knowledge or reasonable cause to believe on the part of a creditor was non-essential.

Judge Rogers said:

> "It is to be observed that under the Bankruptcy Act a preferential payment to be avoided must have been received by one who had

'reasonable cause to believe' that it would effect a preference; while under the New York Stock Corporation law the invalidity of the payment is not made to depend upon the knowledge of the one receiving payment that it is a preferential payment or upon his having reasonable cause to believe that it is a preferential payment."

In *Cardoso vs. Brooklyn Trust Co.,* 228 Fed. 333, the same Court held that a Trustee in Bankruptcy might avoid a preference under the state law by virtue of Sec. 70 E of the Bankruptcy Act.

In *McGill vs. Commercial Credit Co1,* 243 Fed. 637, the District Court of Maryland said:

"Within the meaning of the New York statute, insolvency is a general inability to pay in the course of business the liabilities existing and capable of being enforced. *Brouwer vs. Harbeck,* 9 N. Y. 389. For its application it is not necessary that knowledge or notice of insolvency shall have been brought home to the creditors receiving the preference.

"The Circuit Court of Appeals for the Second Circuit has held that the Trustee in Bankruptcy may recover property the transfer of which this state statute declared void. *Grandison vs. Robertson,* 231 Fed. 785, 145 C. C. A. 605. In that case the Trustee's authority was derived from Sec. 67 E of the Bankruptcy Act (Comp. St. 1916, Sec. 9651); but in *Cordoso vs. Brooklyn Trust Co.*, 228 Fed. 333, 142 C. C. A. 625, the conveyance to set aside was made nine months before bankruptcy and the Trustee relied upon the provision of Sec. 70 E. Under the

construction placed upon this state statute by the highest court of New York, its application is not limited to cases in which the corporation has refused to pay its notes or other obligations when due. It is declared that the enactment was intended to prevent unjust discrimination and preferences among creditors of insolvent corporations or those bordering upon insolvency. *Cole vs. Millerton Iron Co.,* 133 N. Y. 164, 30 N. E. 847, 28 A. S. R. 615; *Casser vs. Barnard,* 156 App. Div. 724, 141 N. Y. S. 659; Id. 209 N. Y. 570, 103 N. E. 1122."

Referring to Sec. 70 E, 7 C. J. 182, says:

"The effect of this provision is to give to the Trustee the same rights with respect to such transfers as are conferred on the bankrupt's creditors, or any of them, by the common law or the statutory law of the state where the property is located."

Collier on Bankruptcy (1921 ed.), page 1178, referring to Sec. 70 E, says:

"It is the corollary of Sec. 67 B, and means simply that if a creditor could have avoided any transfer (not merely a lien) under the laws of the state, the Trustee can do the same,"

and cites *Williams vs. Davidson,* 104 Wash. 315, 176 Pac. 334.

The Supreme Court of the State of Washington has held that a Trustee in Bankruptcy may set aside a preference as defined by the Bankruptcy Act, or as defined by state law.

Benner vs. Scandinavian American Bank, 73 Wash. 488, 131 Pac. 1149.

Williams vs. Davidson, 104 Wash. 315, 176 Pac. 334.

The decision of the United States Supreme Court above quoted that the Trustee may proceed under Sec. 70 E and assert any right that a creditor might assert is conclusive authority for the right of the Trustee here to proceed under both the Bankruptcy Act and the state law. In that case, in the cases in the Second Circuit, and in the Washington cases the Trustee asserted his rights under both the Bankruptcy Act and under the state law.

These decisions are also a full answer to the contention that the Trustee must prove insolvency within the meaning of the Bankruptcy Act under Sec. 67 E; for under Sec. 70 E the Trustee asserts the rights of creditors as they possess them under the state law. Under state law the trustee need prove insolvency as defined by state law, namely, inability to pay bills as they mature in due course.

II.

Stellwagen vs. Clum, 245 U. S. 605.

At the oral argument the district court also inquired if the payment of money was a transfer

constituting a preference.

7 C. J. 157 says:

> "A payment of money to a creditor may constitute a preferential transfer within the meaning of the Bankruptcy Act."

In *Pirie vs. Chicago Title Electric Co.*, 182 U. S. 438, 21 S. Ct. 906, 45 L. Ed. 1171, the Court said:

> "It would be anomalous in the extreme that any statute which is concerned with the application of debtors and the prevention of preferences to creditors, the readiest and most potent instrumentality to give a preference, should have been omitted. Money is certainly property, whether we regard any of its forms or any of its theories."

Held, payment of money was a transfer of property making a preference.

See *Remington on Bankruptcy,* Sec. 1283-1289.

Union Trust Co. vs. Amery, 72 Wash. 648, 131 Pac. 199.

III.

Some slight contention was made by appellees that other creditors than those named in our opening statement received preferences at the hands of bankrupt. They point out that payments were made to said creditors by the bankrupt during 1921. The

status of this matter is fully set out in the Record at page 157. It can best be explained by example.

Western Dry Goods Co. filed its claim with the Referee for $991.85. It appears that on January 1, 1921, the bankrupt owed said claimant $904.66, that claimant sold bankrupt, within four months of bankruptcy, $1,016.71 worth of goods, and received from bankrupt payments of $929.52 within said four months. Comparing said sales of merchandise and said payments it is at once apparent that said claimant delivered to bankrupt and added to its assets $1,016.71 worth of merchandise and took from bankrupt $929.52 in money, that the net result is to increase the assets of bankrupt within the four months' period by some $86.00, rather than to deplete the estate of the bankrupt. Under such circumstances there could not be any preference to Western Dry Goods Co.

Remington on Bankruptcy, Sec. 1419:

> "After the insolvency, the aggregate result to the trust fund, as to whether it has been enriched by the transaction taken as a whole, notwithstanding the alleged preference, is to govern.
>
> "And the different items of payment, new goods, credits, etc., are not to be taken separately, nor are merely these new credits com-

ing after any particular payment by the debtor to be offset against the payments preceding the particular credits. But the transactions after the insolvency within the four months are to be taken as a whole and the net result taken."
Mr. Remington, in Sec. 1420, says:

"Where the entire transaction—all the items of the running account—occur within the four months' period and after insolvency, payments on account are not preferential and need not be surrendered."

See also:

Jacquith vs. Alden, 189 U. S. 78.

Peterson vs. Nash, 112 Fed. 311 (CCA Minn.)

Re Geo. M. Hill Co., 130 Fed. 315 (CCA Ill.)

Yaple vs. Dahl-Millakan Grocery Co., 193 U. S. 526.

In re Grocer's Baking Co., 266 Fed. 900, 7 C. J. 168.

IV.

State Trust Fund Theory.

The Supreme Court of the State of Washington has held in a great many cases that an insolvent corporation cannot prefer its creditors, *no matter what the good faith of the creditor may be.*

The first announcement of this rule arose where a mortgage was given by an insolvent corporation to a bank and there was no finding that the bank knew that the corporation was insolvent.

The court said:

> "This will not do in the case of an insolvent corporation, no matter what the good faith of the creditor is. When it has reached a point where its debts are equal to, or greater than its property, and it cannot pay in the ordinary course, and its business is no longer profitable, it ought to be wound up and its assets distributed.
>
> "The purpose in thus placing insolvent corporations in the possession of the courts can only be that their assets may be distributed ratably to creditors. A general assignment without preferences does not defeat this purpose, but, if the estate of a corporation comes into court, or into the hands of the assignee, burdened with preferences, there is an end of equal distribution, and the object of the law is defeated."

Thompson vs. Huron Lbr. Co., 4 Wash. 600, 30 Pac. 741, 31 Pac. 25.

In *Conover vs. Hull,* 10 Wash. 673, 39 Pac. 166, 45 A. S. R. 810, is found an exhaustive and able opinion by Judge Dunbar defending the trust fund theory, and laying down the principle that a voluntary preference by an insolvent corporation was void under the holding of *Thompson vs. Huron Lbr. Co., supra.*

Judge Dunbar quotes Sec. 803 of Morawetz, from which we extract:

> "If a corporation, whose assets are not sufficient to satisfy all of its creditors in full, can prefer certain creditors, leaving others unpaid, this must be by virtue of a power reserved by implication to the company and its agents. But this power cannot justly be included in the general powers of management which a corporation must necessarily possess over its property in order to carry on its business, and further the purposes for which the company was formed."

Judge Dunbar said:

> "When we come to think that this preferred distribution is made by the managers, who represent the stockholders who are in no way responsible for the debt, or at least that portion of it which is in excess of their liabilities, why should they ,thus disinterested, be allowed to confer these benefits upon favorites to the exclusion of the rights of other honest creditors who have helped to furnish the means which constitute the very fund which is now being distributed to the exclusion of their interests? Certainly, it is but a just provision of law which holds that this fund, under such a condition, must be held intact as a trust fund for the equal benefit of all the creditors.
>
> "If the theory of the appellants were true, that the trustees of a corporation could prefer its creditors, and if they can prefer them at all they can prefer them to the extent of all the funds of a corporation, the Court of Equity, before whom the case was brought

for judgment, would sit helpless and with empty hands; for it would be but a mockery of justice to bring the affairs of an insolvent corporation to a court for adjustment and distribution when all the substance of the corporation had been transferred to the pocket or till of a favored creditor.

"And so it is with the corporations in this state. Parties who deal with these corporations under the law rely exclusively upon the funds of the corporation, recognizing the fact that they have no redress upon the private means of the stockholders; and every principle of fair dealing demands, under such circumstances, that the fund upon which they rely and to which they extend their credit should be held as a sacred trust, and equitably and justly distributed by the court for their benefit.

It may be admitted that in this case Judge Dunbar held that the proof must show (1) the corporation insolvent, and (2) that creditors had reasonable cause to believe that debtor was insolvent; for he said:

"In *Buchanan vs. Smith,* 16 Wall. 277, it was held that the creditor had reasonable cause to believe his debtor insolvent when such state of facts is brought to his notice respecting the affairs and pecuniary condition of his debtor as would lead a prudent business man to the conclusion that he, the debtor, is unable to meet his obligations as they mature in the ordinary course of business."

But later in *Tacoma Ledger Co. vs. Western Home Bldg. Assn.,* 37 Wash. 467, 79 Pac. 992

(1905), where an insolvent corporation sold its assets to another corporation without making provision for payment of its debts, and the purchaser had no knowledge of either insolvency or of any debts, Judge Dunbar said:

> "If the corporation was in failing circumstances at the time of the transfer, the answer of the defendant that it was not aware of the indebtedness, will not avail it. For, with or without that knowledge on the part of the appellant, the property of the corporation is still a trust fund for the benefit of creditors."

Since the above decision was rendered in 1905 the court *has always held that knowledge, belief or reasonable cause to believe need not be proved, that the good faith of the creditor is immaterial.*

In *Jones vs. Hoquiam Lbr. & Shingle Co.,* 98 Wash. 172, 167 Pac. 117, the Klipsun Lbr. Co. was unable to meet its debts as they matured in the ordinary course of business and transferred a piece of land worth $650 in payment of a debt of $650 on September 28, 1914. The company continued to do business as a going concern until August 31, 1915, and according to the briefs filed in that case the Klipsun Lumber Co. transacted $100,000 worth of business after said transfer on September 28, 1914, and before the appointment of a receiver on August 31, 1915.

There was no finding that the creditor knew, believed, or had reasonable cause to believe that the Klipsun Lumber Co. was insolvent. Defendant contended the transfer was in good faith on the part of both debtor and creditor and that it had no knowledge of insolvency and that, therefore, there was no preference under the law of Washington.

Judge Holcomb answered this argument as follows:

> "This court, since the case of *Thompson vs. Huron Lumber Co.,* 4 Wash. 600, 30 Pac. 741, 31 Pac. 25, has adhered to the doctrine that, although a private debtor may prefer creditors even to the exhaustion of his property, this will not do in the case of an insolvent corporation, *no matter what the good faith of its creditors is;* that, when a corporation has reached a point where its debts are equal to or greater than its property and it cannot pay in the ordinary course and its business is no longer profitable, it ought to be wound up and its assets distributed; that no device can receive the countenance of the courts which provides for an indefinite continuance of its corporate life against the protests of those who are entitled to share in its property, be it large or little. The doctrine of that case was discussed and reaffirmed in *Conover vs. Hull,* 10 Wash. 673, 39 Pac. 166, 45 Am. St. 810, and has been repeatedly adhered to by this court down to *Benner vs. Scandinavian American Bank,* 73 Wash. 488, 131 Pac. 1149, Ann. Cas. 1914-D, 702." (Italics ours.)

In *Benner vs. Scandinavian American Bank,* 73 Wash. 488, 131 Pac. 1149, the Gawley Foundry & Machine Works, on July 9, 1909, gave a bill of sale to the bank of a coasting vessel for the sum of $5,000, to apply on its account. The company continued to do business and was a going concern until it was adjudged a bankrupt on January 19, 1910. The court said:

> "The machinery company was in *straightened circumstances* long prior to its settlement with the appellant bank, a condition which the officers of the bank knew, although they may not have known its exact situation. It was found by the trial court, and we think the evidence justifies the finding, that the machinery company was, at the time of the settlement, *wholly insolvent,* that its assets did not exceed $20,000, while its liabilities exceeded $100,000. Later on, actions were started against the machinery company by certain of its creditors, in one of which a default judgment was entered.
>
> "In this state it is the rule that a domestic corporation cannot, after insolvency, prefer its creditors; but, on the contrary, its property is from thenceforth regarded as a trust fund for the benefit of all its creditors, and any transfers or mortgages thereof after insolvency, which have the effect of preferring one creditor over another, are void."

In *Williams vs. Davidson,* 104 Wash. 315, 176 Pac. 334, the trustee in bankruptcy sued to recover

preferences prohibited by the Bankruptcy Act and by the state law. The court held there was no proof of "reasonable cause to believe" and hence a case was not made out under the Bankruptcy Act. The court then said:

> "However, appellant's right of recovery is not limited to the bankruptcy law, but if the transfer is preferential and void under the law of this state, he is entitled to recover. The trust fund doctrine, as applied to insolvent corporations, was announced by this court in *Thompson vs. Huron Lumber Co.,* 4 Wash. 600, 30 Pac. 741, 31 Pac. 25, and was exhaustively discussed, considered and reaffirmed in *Conover vs. Hull,* 10 Wash. 673, 39 Pac. 166, 45 Am. St. 810, and has been followed in an unbroken line of decisions ever since that time. So that if anything may be said to be settled, this doctrine has become the settled law of this state, and we cannot depart from it. The trust fund doctrine, from first to last, is to the effect that the property and assets of an insolvent corporation constitute a trust fund in the hands of the managers of the corporation for the benefit of each and all of its creditors ratably, and although a private debtor may prefer creditors, even to the exhaustion of all his assets, an insolvent corporation will not be permitted to do or suffer anything which will permit one or more creditors to obtain a preference, no *matter what the good faith of such creditors may be.*" (Our italics.)

In *Nelson vs. Svea Publishing Co.,* 178 Fed. 136, Judge Hanford said:

"The rule deducible from the decisions of the State Supreme Court is this: The assets of an insolvent corporation constitute a trust fund for the payment of its debts, in which all of its creditors are entitled to share ratably; and preferences given voluntarily by an insolvent corporation are void, as to non-preferred creditors."

14-a C. J. 898 says:

"The rule denying the right to prefer creditors has been held to apply without reference to the want of knowledge on the 'part of the preferred creditor of the character of the transfer and of the financial condition of the corporation, although as to this, there is contrary authority.' "

Sustaining the text in *Furber vs. Williams Co.,* 21 S. D. 228, 111 N. W. 548, 8 L. Rans. 1259; *Jones vs. Hoquiam Lbr. Co.,* 98 Wash. 172, 167 Pac. 117; *Thompson vs. Huron Lbr. Co.,* 4 Wash. 600, 30 P. 741, 31 P. 25. The contrary authority is *Ford vs. Lamson,* 17 Ohio Cir. Ct. 539.

INSOLVENCY UNDER STATE LAW.

So far as the rights of creditors are concerned, a corporation is insolvent under the laws of the State of Washington when it is unable to meet its bills as they mature in the ordinary course of business.

Thompson vs. Huron Lbr. Co., 4 Wash. 600, 30 Pac. 741, 31 Pac. 25.

Nixon vs. Hendy Mach. Wks., 51 Wash. 419, 99 Pac. 11.

Ronald vs. Schoenfield, 94 Wash. 238, 162 Pac. 43.

Simpson vs. Western Hdw. & Metal Co., 97 Wash. 626, 167 Pac. 113.

Jones vs. Hoquiam Lbr. & Shingle Co., 98 Wash. 172, 167 Pac. 117.

Williams vs. Davidson, 105 Wash. 315, 176 Pac. 334.

In the *Jones* case the court said:

"The test of insolvency of a domestic corporation in this state is not the same as the test under the federal bankruptcy acts. In *State ex rel Strohl vs. Superior Court,* 20 Wash. 545, 56 Pac. 35, 45 L. R. A. 177, where it was alleged that the corporation was insolvent in the sense that it was wholly unable to meet its obligations as they matured in the ordinary course of business, the court, after citing the section of the federal bankruptcy act (30 Stat. L. 544, U. S. Comp. St. 1916, 9585) providing that, 'A person shall be deemed insolvent . . . . whenever the aggregate of his property . . . . shall not at a fair valuation be sufficient in amount to pay his debts,' said:

" 'It will thus be seen that the allegations of the complaint in the suit for the receiver in the case at bar would not conclusively make a case under the federal bankruptcy law, ...

this court has uniformly affirmed the doctrine that the assets of such a corporation are always a trust fund to be administered in equity for the benefit of creditors ratably and equally.'

"In *Nixon vs. Hendy Machine Works,* 51 Wash. 419, 99 Pac. 11, it was said:

" 'If the . . . company was an independent concern, the evidence plainly shows that it was insolvent in that it was not able to pay its debts in due course of business, and this is the test of insolvency established by this court where the rights of creditors are involved.'

"Such being the rule in this state, and it being well established by the evidence that the Klipsun Lumber Company was insolvent under that rule at the time the conveyances of the real estate was made, the conveyance was conclusively a preference and therefore unlawful, and can be set aside at the suit of the receiver of the insolvent for the benefit of all creditors of the same class."

In the *Ronald* case the court said:

"It is abundantly proven by the testimony of witnesses on both sides, and by the admissions of respondent himself, that the company was not able to pay its debts in due course of business. Such is the test of insolvency adopted by this court."

In the *Simpson* case the court said:

"This court has held that the assets of an insolvent corporation constitute a trust fund for the payment of tis debts, in which all of its creditors are entitled to share ratably. *Con-*

over vs. Hull, 10 Wash. 673, 39 Pac. 166, 45 Am. St. 810; *Nixon vs. Hendy Machine Works,* 51 Wash. 419, 99 Pac. 11. And that a corporation that is not able to pay its debts in due course of business is insolvent so far as creditors are concerned, and cannot prefer a creditor. *Nixon vs. Hendy Machine Works, supra; Ronald vs. Schoenfield,* 94 Wash. 238, 162 Pac. 43. A conveyance by a domestic corporation after insolvency, preferring creditors, is void, as the property is a trust fund for all of its creditors. *Benner vs. Scandinavian American Bank,* 73 Wash. 488, 131 Pac. 1149, Ann. Cas. 1914-D 702."

Claimants knew bankrupt was insolvent as that term is defined in Washington. The Carson, Pirie, Scott & Co. account commencing January 1, 1921, was over one year old and was past due for more than eight months.

Applying the test of insolvency laid down in *Conover vs. Hull, supra,* to the Carson, Pirie Scott & Co. account, it is apparent that Carson, Pirie, Scott & Co. knew from its own account that debtor was not paying its bills as they matured in the ordinary course of business; and refused to sell any more merchandise until its account was paid up. Therefore, Carson, Pirie, Scott & Co. knew that this concern was insolvent.

Applying the test of insolvency to the bank, it likewise knew from its own account as well as

from the condition of bankrupt's business, that it could not pay its bills in due course of business and, therefore, knew that bankrupt was insolvent.

But the Supreme Court of Washington, like the court in New York, holds that the good faith of the creditor is immaterial and that proof of reasonable cause to believe is non-essential; that a preference is void whether the creditor knew the concern was insolvent or not.

CONCLUSION.

The trustee believes the ordinarily careful and prudent man, the ordinarily intelligent business man, under the facts and circumstances shown to exist, would have reasonable cause to believe that the bankrupt was insolvent and that shutting off the credit in the one case and the determined stand for payment in the other, etc., etc., was for the purpose of getting the money ahead of the other creditors; that a preference was plainly established under the Bankruptcy Act.

But whether or not these creditors had reasonable cause to believe that the bankrupt was insolvent at the time payments were made, whether

or not creditors acted in good faith in receiving said payments—these terms being interchangeable, according to *Bassett vs. Evans,* 253 Fed. 532 (C. C. A. 8)—the payments made to these creditors were preferences under the law of the State of Washington where insolvent corporations are prohibited from preferring one creditor over another under a sound public policy known as the Trust Fund Theory, by virtue of which the asets of an insolvent corporation are held to be a trust fund for equal and ratable distribution among all the creditors of the corporation.

Trustee respectfully submits that he is entitled to a judgment under the Bankruptcy Act on the facts, or that he is entitled to a judgment on the facts found by the referee and the court as a matter of law under the law of the State of Washington.

Respectfully submitted,

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